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EXCEPTION

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Arizona Corporation Commission

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IN THE MATTER OF THE
APPLICATION OF ARIZONA PUBLIC
SERVICE COMPANY FOR AN ORDER
OR ORDERS AUTHORIZING IT TO
ISSUE, INCUR, OR ASSUME
EVIDENCES OF LONG-TERM
INDEBTEDNESS; TO ACQUIRE A
FINANCIAL INTEREST OR
INTERESTS IN AN AFFILIATE OR
AFFILIATES; TO LEND MONEY TO
AN AFFILIATE OR AFFILIATES; AND
TO GUARANTEE THE OBLIGATIONS
OF AN AFFILIATE OR AFFILIATES

DOCKET NO. E-01345A-02-0707

EXCEPTIONS OF PANDA GILA RIVER, L.P.

Pursuant to A.A.C. R14-3-110(B), Panda Gila River, L.P. (PGR) submits the following exceptions to the Recommended Opinion and Order ("Recommended Order") issued by Chief Administrative Law Judge Lyn Farmer on March 12, 2003.

PGR does not oppose APS's Application. However, PGR agrees with Judge Farmer that the Commission's "foremost concern and guiding principle [should be] what is in the best interests of the ratepayers of APS." Recommended Order at 23, lines 21-22. In applying this general standard to the evidence in this proceeding, the Recommended Order errs in concluding that credit support from Arizona Public Service Company ("APS") to Pinnacle West Capital Corporation ("PWCC") or Pinnacle

West Energy Company ("PWEC") is in the public interest, and that APS should be allowed to choose between the loan and guarantee options in providing such credit support.

I. THE EVIDENTIARY RECORD DOES NOT SUPPORT THE CONCLUSION THAT THE REQUESTED LOAN IS IN THE PUBLIC INTEREST

The Recommended Order concludes that APS's Application should be approved and that the proposed financing should proceed because APS ratepayers will be harmed if APS's credit is downgraded following a downgrade of PWCC's credit if the Application is denied. Recommended Order at 22. The Recommended Order notes, however, that while there is some evidence to support APS's claim that PWCC will be downgraded if the Application is denied, "[t]he likelihood of an APS downgrade in the event of a PWCC downgrade is more speculative." *Id.* at 23, line 2. The Recommended Order further concludes that PGR witness Susan Abbott's analysis, that APS would be downgraded if it incurs additional debt to loan to PWEC, but that PWCC would *not* be downgraded if it refinanced existing debt, "makes sense." Logically, then, the evidence shows that neither PWCC nor APS should be downgraded if the Application is denied, but that APS might be downgraded if the Application is approved.

The Recommended Order concludes that, despite the logic of this analysis, the Commission should nevertheless approve the proposed financing because, while it is not clear what APS told the rating agencies, "it is possible that APS may be downgraded *if APS led the rating agencies to believe that the assets are going to be rate based, and that the assets had an assured cash flow.*" Recommended Order at 23, lines 17-19 (emphasis added). Thus, even though the Recommended Order concludes that it is not clear that APS would be downgraded if the Application is denied, and that, logically, it makes sense that APS *would not* be downgraded in such circumstances, the Commission

nevertheless should approve the Application if APS gave the rating agencies the impression that the PWEC assets might be included in APS's rate base.

In addition, the Recommended Order concludes that Commission action is appropriate here even though "a public service corporation borrowing funds to lend to an affiliate to refinance assets [generally] would not be considered to be in the public interest, to be consistent with sound financial practices, not to be within the proper performance of its duties as a public service corporation." Recommended Order at 27, lines 10-12. In determining that the requested credit support is in the public interest, the Recommended Order refers to the FERC's recent change in its policy regarding approval of utility securities and other liabilities, and notes the similarities between Section 204 and Arizona's financing laws, and assesses APS's proposal under the new FERC policy. Recommended Order at 30.

As the Recommended Order concedes, the FERC, in its recent *Westar* decision, modified its policy regarding utility debt issuances to ensure that regulated utilities do not borrow substantial sums of money and use the proceeds to finance non-utility businesses. *Westar Energy, Inc.*, 102 FERC ¶ 61,186 (2003), *slip op.* at 7.¹ Clearly, that is exactly what APS is proposing to do here – borrow \$500 million to finance its non-utility merchant generation business. The Recommended Order concludes that FERC would nevertheless approve this transaction, as it did the *Westar* proposal, because the unsecured APS debt would "follow the assets" given APS's security interest in the PWEC assets. Recommended Order at 31. The *Westar* order does not state, however, that utilities divesting utility assets to their non-utility affiliates can take a security interest in the divested assets, but requires that "if the non-utility assets are

¹ The Recommended Order incorrectly refers to the *Westar* order as being issued in Docket No. ES02-52. The correct FERC docket number is ES02-51.

divested or 'spun off' then a proportionate share of debt must 'follow' the associated non-utility assets by being divested or 'spun off' as well." *Westar* at ¶ 21 (p. 7). Even if it is true that the PWEC assets are already spun off, under the financing proposal, the debt is *not* spun off or divested, and therefore, the proposal would comply with the new FERC policy only if the debt itself were "divested" directly to PWEC. Therefore, to the extent the Commission concludes that FERC policy under Section 204 is persuasive, such policy supports rejection, not approval, of the Application. At the very least, even applying the Recommended Order's erroneous analysis, the financing option that most clearly fits the new FERC policy is the guarantee, which maintains proper separation between the utility and non-utility affiliates.

II. THE EVIDENCE SUPPORTS APPROVING A GUARANTEE RATHER THAN A LOAN

As discussed above, PGR believes that the evidence in this proceeding demonstrates that APS and its ratepayers will be harmed if the Application is approved, and will not be harmed if the Application is denied. If, however, the Commission agrees with the hearing officer that APS needs to take some action to avoid potential harm to ratepayers, the Commission should approve a guarantee, rather than a loan.

At the hearing in this proceeding, PGR demonstrated that a direct loan from APS to PWEC would decrease regulatory insulation between the affiliates, would undermine wholesale competition, would make it more likely that the PWEC assets would ultimately be included in APS's rate base, and would be worse for APS's overall credit quality than would a guarantee. Nor is there evidence in the record that the guarantee alternative would not fully address the issues raised in APS's Application. The Recommended Order acknowledges PGR's evidence and contains no discussion of *any* evidence or analysis disputing PGR's argument that the guarantee would be

preferable to the loan. The Recommended Order states that PGR's concerns about regulatory insulation are legitimate and should be addressed in this docket, but concludes that, with appropriate conditions, the loan option would not be *harmful* to competition or to APS's ratepayers. Recommended Order at 24.

The clear implication from this discussion is that, standing alone, the guarantee option would be preferable to the loan option, but that appropriate conditions can ensure that the loan is no *worse than* the guarantee. This is insufficient grounds for the Commission to allow the loan option to proceed, given that the Recommended Order also concludes that "it is possible to structure such a guarantee to address the concerns raised by Staff in its proposed conditions to the loan approval." Recommended Order at 26.

III. APS COMPLIANCE WITH THE AFFILIATED INTEREST RULES

The Recommended Order directs Staff to undertake "a preliminary investigation into APS' PWCC and PWEC's actions related to the transition to electric competition, particularly compliance with [the] electric competition rules and with Decision No. 61973 and APS' activities with its affiliates." Recommended Order at 34. PGR agrees. APS and PWEC may have abused their affiliate relationship. *Id.* at 34-36. As the Recommended Order concludes, the credit relief to be provided by APS to PWEC will affect the regulatory insulation between the two affiliated entities, necessitating conditions to the loan approval and ongoing oversight to prevent harm to ratepayers. Under these circumstances, it is vital that the Commission approve the proposed investigation to ensure that past or future acts by APS and PWEC do not harm competition or APS's ratepayers.

IV. RESTRICTION ON REORGANIZATION BY PWEC OR PWCC

As discussed above, the Recommended Order concludes that strict conditions and ongoing Commission oversight of APS, PWEC and PWCC is necessary to prevent harm to competition or APS's ratepayers arising from approval of the financing. PGR agrees that such conditions and oversight are necessary. One of the conditions included in the Recommended Order requires that "neither PWCC nor PWEC shall reorganize or restructure, acquire or divest assets, or form, buy or sell affiliates, or pledge or otherwise encumber the PWEC generation assets during the duration of the loan/guarantee without prior Commission approval." Recommended Order at 33, lines 24-28. While PGR does not dispute that such a condition is appropriate, it is unclear whether the Commission intends that this condition go beyond the existing requirements of the Affiliated Interest Rules. Under the existing Rules, the Commission may reject:

[t]he acquisition or divestiture of a financial interest in an affiliate or a utility, or reconfiguration of an existing affiliate or utility's position in the corporate structure or the merger or consolidation of an affiliate or a utility. . . if it determines that it would impair the financial status of the public utility, otherwise prevent it from attracting capital at fair and reasonable terms, or impair the ability of the public utility to provide safe, reasonable and adequate service.

A.A.C. R14-2-801, 14-2-803(C). The Recommended Order requires APS, PWEC and PWCC to get Commission approval for *any* reorganization, and does not limit the grounds for which the Commission may reject the proposal. Because neither PWEC nor PWCC are parties to this proceeding, it is unclear how conditions going beyond the current Rules will be applied to them. Therefore, the Commission should make clear how it intends to enforce the Recommended Order's proposed restrictions on PWEC and PWCC's activities regarding the PWEC assets.

V. CONCLUSION

PGR generally supports much of the analysis of the Recommended Order. The Recommended Order errs, however, in concluding that APS should be permitted to provide a direct loan to its merchant affiliate, rather than a guarantee. As discussed herein, these recommendations are not supported by substantial evidence, and the Commission should amend the Recommended Order consistent with the proposals herein.

Respectfully submitted,



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